Macro Talking Points

Fixed Income Insights

Week of 26 August 2024

Author

Benoit Anne
Managing Director
Investment Solutions Group

In brief

- **Why this business cycle could be different**
- **Agency MBS confirm their resilience**
- **The case for HY from a total return perspective**
- **Top client questions during the Sweden visit**

This has not been your typical business cycle. The handwriting was on the wall: a recession was coming. All signs pointed to that inevitability. The only problem was that the old toolbox no longer worked. Take the US yield curve. The Treasury yield curve has been inverted for the past 559 trading days.[1] On average, since the early 1970s, every time the yield curve has been inverted, a recession has followed 15 months later. Now, after 26 months of inversion, any recession would be very late.

There are a few reasons why the yield curve may not have worked as a recession indicator this time around. The first is that the US economy has grown less sensitive to higher rates, owing to deleveraging, past mortgage refinancings and stronger cash balances on the part of the consumers and corporates. The second is that, as underscored by our chief economist, Erik Weisman, in the recent past the market was likely of the view that the US Federal Reserve's neutral rate, the so-called r*, was still very low. With that in mind, the sharp rise in the Fed's policy rate caused a major deviation from r*, thereby accentuating the inversion bias. But if the market got that wrong, and r* was indeed higher, the curve wouldn't have inverted by that much. In other words, the US economy could cope with the impact of higher rates a lot better than we had anticipated because the real tightening could have been smaller than it initially looked. The third reason to question the reliability of the yield curve as an indicator is that the Fed owned a massive chunk of US Treasuries as part of its QE program, which may have distorted the yield curve and as a result produced a false positive.

What about the various leading indicators? Whether we are talking about the University of Michigan's consumer confidence index, the Conference Board's LEI or ISM new orders, all these data points still look depressed, hovering around levels that historically have been associated with recessions. But there is a difference between soft data and hard, and what we have observed is how the consumer or firms feel in sentiment surveys hasn't matched up with the reality of stronger macro statistics. Of note: Another recession indicator may not be working: the labor market–based Sahm rule, which was triggered this month. There are good reasons to believe that the significant pick-up in the unemployment rate may not be as bad as it seems, owing mainly to the impact of higher labor supply. To be clear, we are not sure a recession is entirely off the table. But the odds seem to be in favor of a soft landing, and if there is a recession, it will likely be mild and shallow.

Resilience is a positive attribute. In the world of fixed income, some asset classes are riskier and others more defensive. In a way, it is reassuring to see that the asset classes that were supposed to be defensive behaved exactly that way in the midst of the early-August market turmoil. This is particularly the case for agency MBS. Virtually nothing happened to the asset class, with its defensive characteristics in full view. While US IG spreads widened by almost 20 basis points in just three days, agency MBS spreads moved by only 4 bps during that time. Historically, agency MBS has been at the low end of the risk spectrum, displaying a beta to the US Agg of well below 1. In our opinion, it makes sense to have a diversified approach in a portfolio, with a mix of defensive and higher beta asset classes. That resilience comes at a cost, however, especially in terms of relative valuation. Given that agency MBS didn't sell off as much as peers, the valuation backdrop is less inspiring in RV terms. This may justify a more balanced approach for the asset class, at least in the near term. At this juncture, the view on agency MBS taken by our fixed income portfolio manager in charge of mortgage-backed securities, Jake Stone, is a lot closer to neutral compared with the more constructive bias of a few months ago. Not that the technicals or fundamentals have necessarily worsened. It's mainly a tactical valuation call.

The total return case for high yield. High yield is often discussed during the fixed income investment team's meetings, including at the recent internal brainstorm session on risks and opportunities, simply because of its higher vulnerability to a potential growth shock and its challenging spread valuation landscape. But in the words of our co–portfolio manager of the high yield portfolios, Mike Skatrud, HY total yields remain attractive, and unless there is a catalyst for a spread correction, the outlook for total return appears to be broadly positive. Our HY team is more cautious when it comes to excess return expectations, given the tricky spread valuation backdrop. Looking at breakeven yields, it is worth flagging that US high yield produces the highest breakeven yields across global fixed income, thereby pointing to some attractive valuation cushion. To be clear, high yield remains a fundamentally bottom-up asset class, which requires a well-researched security selection process. While the asset class may look attractive from a top-down index perspective, it is important to keep in mind that an active approach to portfolio management is critical, given the elevated credit risk involved.

Mamma Mia! We spent a couple of days in Stockholm visiting clients last week. Here are a few things clients asked us about. On politics, they wanted to discuss the various election scenarios and their impact on fiscal spending and government debt. On monetary policy, clients raised the question of the magnitude of the easing cycles. On macro, the discussion centered on the growth scenarios and risks and whether a recession was likely. The outlook for the USD also came up, and whether to hedge foreign credit exposure. Finally, on fixed income, the key topics revolved around the view on duration, curve positioning, fixed income valuation and global fixed income opportunities, including European credit and emerging market debt.

Endnotes

[1] Source: Bloomberg. US yield curve, spread between the US 10-year UST yield and the 2-year UST yield. An inverted curve corresponds to the difference between the 10-year yield and the 2-year yield being negative. Data as of 23 August 2024.